

May 2000

US Overview:

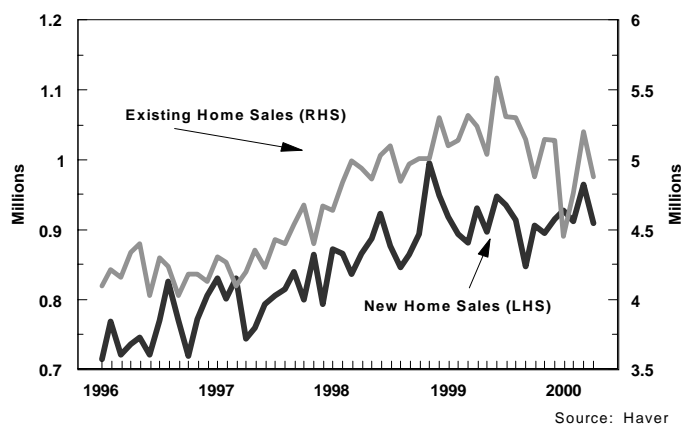
After surging in excess of 5 percent in each of the last three quarters, the economy appears to be slowing somewhat in the current quarter. Recent Federal Reserve rate hikes and stock market weakness appear to be having an effect, although seasonal quirks may also be playing a role. The key question, however, is whether the economy is slowing enough to relieve concerns over rising inflationary pressures. At this point, economists believe that it is too early to make such a pronouncement.

Spring Respite, But Underlying Conditions Still Favorable

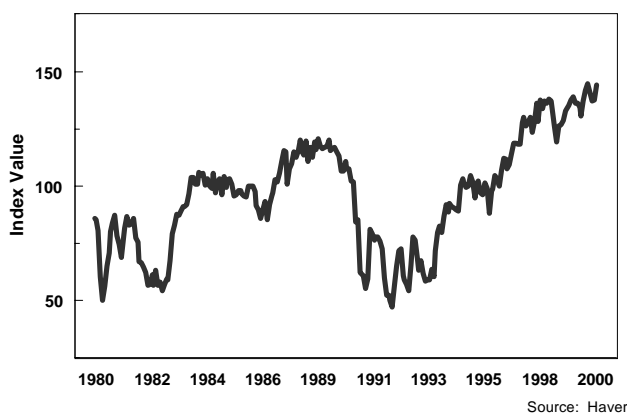
After going on a spending binge in recent months, consumers took a breather in April. Retail sales fell marginally for the month, which tempered the increase in overall personal spending. In addition, housing sales continued to slip back from earlier highs, although they remained strong on a historical basis. Further slowing in this sector seems likely now that 30 year mortgage rates have hit five year highs.

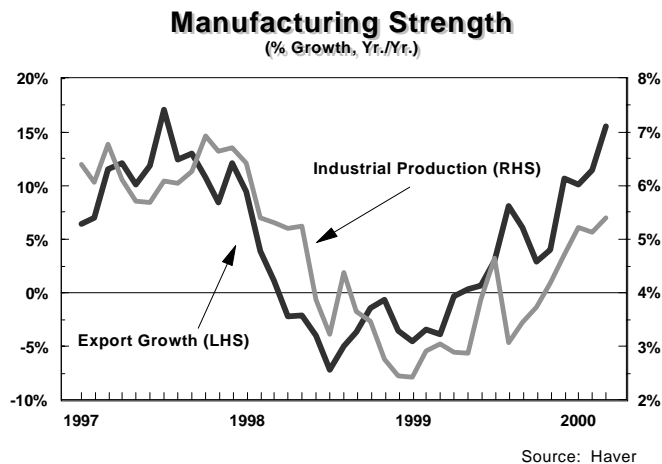
However, economists are reluctant to read too much into recent signs of slowdown. For one, seasonal factors may be behind some of April's weakness – a relatively mild winter likely accelerated spending and construction into the first quarter, thus poaching from the second quarter. Secondly, the factors which propelled the earlier consumer spree persist – job markets remain tight (even with the surprise drop in May private payrolls), incomes are rising, and households are still sitting on roughly \$17 trillion gains in net wealth accumulated between 1994-1999. As a result of these latter factors, consumer confidence leapt to its second highest level on record in May, despite Fed rate increases and stock market weakness. Thus, while consumer demand growth is slowing, it may still maintain a respectable pace.

Housing Market Slows....

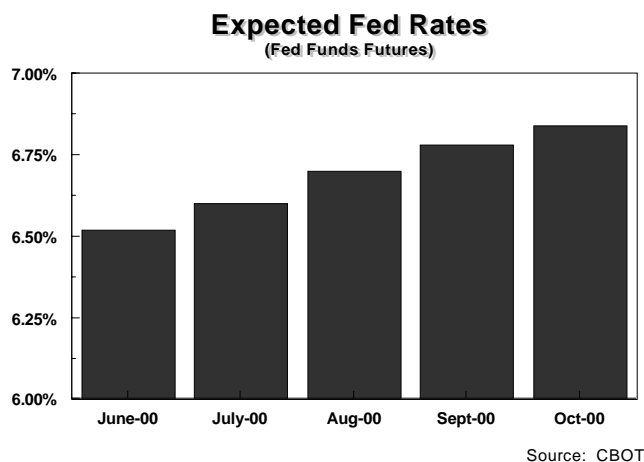


But Consumer Confidence Rises





Furthermore, even as the consumer sector slows, manufacturing is strengthening. Industrial production is increasing, as firms try to rebuild inventories that were depleted in last quarter's consumer binge. Factories are also trying to keep pace with rising demand for US exports, as the global economy strengthens. As such, even with an expected slowdown in consumer activity, Blue Chip forecasters still expect the economy to post nearly 4 percent growth this quarter.



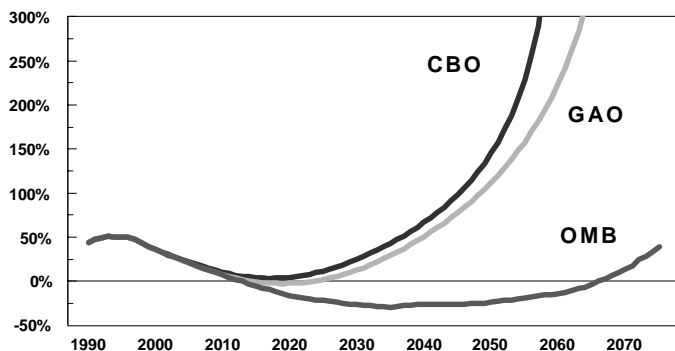
Thus, even though the economy has slowed relative to the last few quarters, it is unclear if it is slowing enough to quell inflation fears. Although economists now believe that the Fed may leave rates unchanged in June, they still look for another 25 basis point rate hike this fall – this would bring the overnight federal funds rate to 6.75 percent.

Selected Issue: Long Range Fiscal Estimates

As surpluses mount, there is growing recognition that today's bounty should be used to shore up our long-run fiscal outlook. The Administration believes this can be done by just paying down the publicly held debt. Others believe that a combination of debt reduction and entitlement reform is needed. What are these views based upon?

One important factor is the output of 75 year budget simulations done by CBO, GAO and OMB. These models use CBO's and OMB's 10 year budget projections as their jumping off point and then extend the fiscal projections based on each agency's long-run economic assumptions and programmatic forecasts by the Social Security and Medicare actuaries. By their nature, these projections are highly uncertain – even small changes in near-term assumptions can have a significant effect when extrapolated for 75 years. As such, policymakers generally use the results of these models for their qualitative message.

Debt-to-GDP Projections



Source: CBO 1999, GAO 2000, OMB 2000, SBC
Assumes Social Security surplus is saved

CBO and GAO's models generate similar results. Under the most likely scenario of "Saving the SS surplus" near-term, both groups still believe that long-term fiscal policy is unsustainable (defined as a debt/GDP level above 150 percent) absent structural entitlement reforms. OMB disagrees – they project that fiscal policy will remain sustainable for the next 75 years even without programmatic reforms. What accounts for this difference in findings?

While there are many differences between the models, the assumptions for discretionary

spending are quite notable. CBO and GAO assume that the ratio of discretionary spending to GDP remains fixed at its 2010 share. In contrast, OMB assumes that discretionary spending is fixed in real dollar terms at its 2010 level, implying that discretionary spending falls from 6.5 percent of GDP today to just 2.3 percent by 2075. While the ratio of discretionary spending to GDP has fallen steadily over the last 30 years, this was largely due to an unwinding of defense spending post Vietnam and the Cold War. Now that the peace dividend has already accrued, many have difficulty believing that the share of discretionary spending to GDP will fall as much as OMB assumes over 75 years.

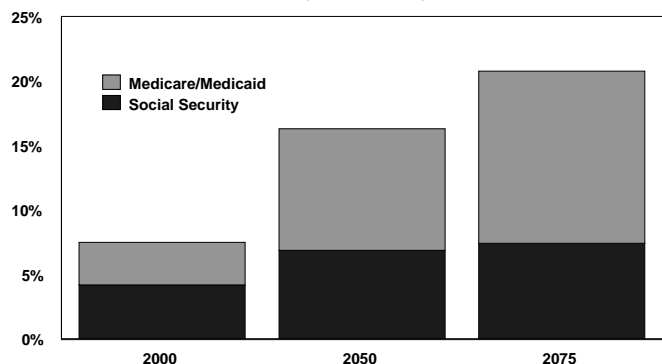
Could this one assumption make the difference in determining whether fiscal policy is sustainable over 75 years? Yes. If CBO used OMB's discretionary assumption, they too would conclude that our fiscal policy is sustainable.

Largely as a consequence of their discretionary assumption, OMB concludes that the US will run surpluses that are large enough to allow the US to pay off its publicly held debt and eventually accumulate net assets (the opposite of net debt) equal to 30 percent of GDP by 2035. In contrast, CBO and GAO do not believe that the US would ever generate enough surpluses to allow it to acquire sizeable net assets under the "Save the SS surplus" approach.

Even if one agreed with the underlying discretionary assumption needed to generate OMB's results, many are skeptical that the US would ever accumulate large net assets – it is questionable whether the electorate would support keeping taxes high in order to allow the government to control an ever larger share of the private economy.

OMB's Entitlement Projections

(Share of GDP)



Source: OMB 2000

Yet, the assumption of net assets is critical to the Administration's argument that debt reduction alone is sufficient to ensure a sustainable fiscal outlook. OMB does not dispute the fact that the share of GDP devoted to entitlement programs will surge over the next century from 7.5 percent today to 20.8 percent by 2075 as the babyboomers age. However, they argue that the US will be able to honor its commitments to the elderly without raising taxes. How? It can raise the needed funds by selling off the US's net assets.

However, even if this scenario were to come true, many question if this would be a desirable outcome. Under OMB's simulations, net assets will eventually be exhausted after 2060. If taxes remained broadly stable at 20 percent of GDP throughout, this would mean that government would exist for the sole purpose of transferring resources from the young to the elderly 75 years from now. Few would consider this an optimal distributional outcome. As such, many question whether debt reduction by itself can lead to a sustainable fiscal outlook absent entitlement reforms.

Main Economic Indicators

	<u>Q3-99</u>	<u>Q4-99</u>	<u>Q1-00</u>	<u>Most Recent</u>
Real GDP Growth	5.7	7.3	5.4	
Consumption	4.9	5.9	7.5	
Trade Deficit (\$bn)	-72.6	-75.5	-86.3	-30.2 (Mar.)
Unemployment Rate	4.2	4.1	4.1	4.1 (May)
Productivity Growth	4.7	6.9	2.4	
CPI Inflation	2.3	2.6	3.2	3.0 (Apr.)
30 Year Treasury Yield	6.1	6.5	6.0	6.0 (May)
Dow	10,400	11,500	10,900	10,600 (May)

In May, Blue Chip asked their economists if US financial markets were being too complacent about the risks of higher inflation.

